Financial Accounting
Standards Board

Joint Conceptual Framework Project

Consideration of One Element to Replace L&E

February 2007 Board Meetings

International Accounting
Standards Board

Disclaimer

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Overview

- Why are we considering replacing the liability and equity elements?
  - Diminishing utility (relevance) of representing an entity’s instruments in two distinct components
  - Increasing difficulties in distinguishing hybrid financial instruments that have different degrees of characteristics of liabilities and equity
  - Boards’ approved project plan calls for consideration of alternatives to the liabilities and equity elements

Approved Project Plan

- Joint project added to agendas--October 2004
- Phase B—To address elements of financial statements
- Milestone V—To consider alternative<u>s</u> to liabilities and equity elements and issues about that distinction if retained
  - Boards identified 7 specific cross-cutting issues (November 2006 IASB AP3A; FASB #43, paragraph 43)

Milestone V
Liabilities and Equity

- Cross-cutting Issues for Elements Milestone V
  - 25: Should there be a distinction between liabilities and equity?
  - 26: Should there by only two elements?
    Why not three–debt, equity and “dequity”?
  - 27: How should liabilities and equity be distinguished from each other (for example, shares puttable at fair value)?
  - 28: Should all elements be defined (if so, will anything fall through the cracks between the definitions), or should one be a residual (if so, which one)?
  - 29: Should *equity* (once determined) be divided into various sub-classes (for example, reporting of parent and non-controlling interests from the investor’s perspective as well as the issuer’s)? If so, is that division for presentation purposes only, or does it have broader implications?
  - 30: Should minority interests be part of equity?
  - 31: If settlement is to be in the entity’s own shares (or equity instrument), can the entity have gains or losses from transacting in its own equity instruments?

Should there Be a Distinction?

- November 2006, Boards discussed the first two cross-cutting issues--alternatives
  - Should there be a distinction?
  - Should there be more than two elements?
- Boards directed the staff to:
  - Continue the considerations of improvements to the liabilities definition (Milestone IV), <u>and</u>
  - Explore alternative<u>s</u> to the L&E distinction but to emphasize the single element alternative first.

Objective of This Meeting

- To begin exploring one of the alternatives
  - replacing L&E with a single element
  - tentatively called *claims*
- Does claims approach have promise?
- Are we on the right track?
  - If yes, seek direction for continuing steps
  - If not, seek direction for getting on track or for other alternatives, including the remaining cross-cutting issues for L&E milestone

Are we on the Right Track?

- Assuming Boards agree we are on the right track we will seek comments on tentative definitions
  - Claims are present interests of others in the entity as a whole or in specific assets of the entity
  - Claims are present economic burdens for which the entity has a present obligation or duty to which claimants have an interest

But First . . .
Is The Promise Sufficient?

- The staff thinks a single element approach for all claims has promise
- Both Boards noted potential benefits when they directed the staff to begin exploring alternatives and to emphasize the claims approach first
- But, some members think a single element approach is a dead-end, poor use of resources
- Some members may now be concerned with the potential scope and significance of changes that could:
  - Extend the project timeline and delay implementing other benefits of improved framework
  - Require significant benefits to justify potential disruptions

So, What Are the Potential Benefits?

- Improve **understandability** and **faithful representation** of items of claims ranging from pure liabilities to pure equity
  a. Trade payables
  b. Employee obligations
  c. Product warranties and service guarantees
  d. Short-term borrowings for current operations
  e. Taxes payable
  f. Mortgage loans
  g. Bonds
  h. Contingent equity financing items
     a. Convertible bonds
     b. Written options giving holders right to purchase entity stock
  i. Temporary equity items
     a. Mandatorily redeemable preferred stock
     b. Puttable stock
  j. Preferred Stock
  k. Interests of minority shareholders in subsidiaries
  l. Common Stock (voting and nonvoting)

Potential Benefits, continued

- Aligns elements with real-world economic phenomena
  - **Resources,** and
  - **Claims to those resources**
- Affirmative definitions for each element of a statement of financial position (assets and claims)
  - Thus, an entity's issuance of a financial instrument can be evaluated without the need to determine if it is **not** an element.
- Eliminates present definitional problem:
  - <u>Equity</u> is defined as the residual interest in the assets of an entity that remains after deducting [all] its liabilities
  - But, some entity issuances of financial instruments are neither liabilities nor pure residual interests in the entity

Potential Benefits, continued

- Consistent with discussion of objectives of financial reporting in Boards' Preliminary Views (¶s OB18-OB26)
  - To help present and potential investors and creditors . . . financial reporting should provide information about the **economic resources** of the entity (its assets) and the **claims to those resources** (its liabilities and equity).
  - Information about the effects of transactions and other events and circumstances that change **resources** and **claims to them** is also essential.

Potential Benefits, continued

- Benefits for L&E project efforts:
  – Could help, as some members suggested, determine conceptual basis for the alternatives being considered
  – Alternatives being considered would not be inconsistent with element definitions
  – Allows Boards to shift focus
    - Away from drawing definitional lines that seemingly are prejudging how to measure particular claims
    - To determining which changes in items are determinant of income and which are distributions of income to claimants

Potential Benefits, continued

- Benefits for FSP project efforts:
  - Alternatives being considered would not be inconsistent with claims approach and its element definitions
  - Could allow for more meaningful presentation of:
    - An entity's value creating activities as distinguished from its financing, which would better align with perspectives of investors, financiers, and economists
    - The right-hand side of balance sheet, for example, based on seniority of claims
  - Could allow for eliminating:
    - Accounting artifacts having diminished relevance (for example, paid-in capital, retained earnings, and accumulated OCI)
    - Interpretations and other guidance directed at what seems like an unending need to police the line between liabilities and equity

So, What Are the Potential Concerns?

- Memo discusses implications of a change to two elements: assets and claims. Two of significance are:
  - “Income” could be redefined
  - Set of financial statements and the inter-relationships of elements could change
- We may have placed too much emphasis on **possible** changes, including some far-reaching possibilities that are neither necessary nor likely. For example:
  - Statements of Assets and of Claims rather than a balance sheet
  - Measuring “pure equity” and other items of equity directly rather than indirectly as a residual
  - Perhaps going so far as Assets ≠ Claims

Potential Concerns, continued

- Some members suggested that replacing liabilities and equity with a single element could:
  - Go beyond intended project objective of developing a common and improved conceptual framework.

    The goals for the project include updating and refining the existing concepts to reflect changes in markets, business practices, and the economic environment in the two or more decades since the concepts were developed. The Boards also intend to improve some parts of the existing frameworks, such as recognition and measurement, as well as to fill some gaps in the frameworks. [PV, ¶P6]
  - Delay finalizing other improvements
  - Require more resources than planned
  - Result in incremental improvements that would not be sufficient to justify disruptions to practice and costs to preparers and users

Additional Observations

- Elements are an important but small part of entire framework
  - Recognition
  - Measurement
  - Presentation and disclosures
- We prefer to avoid dead-ends but elements alone will not tells us which pathways to take
- We wish to remain open-minded so as not to cause the Boards to pass up fruitful alternatives
- Boards' FSP project and 1990 FASB DM on L&E provide a reasonable set of financial statement alternatives (parameters) for consideration

Additional Observations, continued

As one of England’s greatest literary figures, Dr. Samuel Johnson said:

> nothing will ever be attempted if all possible objections must be first overcome.

Staff Suggests

- Boards continue with two tracks for now
  - Improving liabilities definition (Milestone IV)
  - Exploring and developing further the claims approach (Milestone V)
- Boards discuss potential pros and cons of the claims approach with their advisory councils and other constituents

Board Discussion & Questions

1. Is the staff on the right track with the development of the claims approach, including the tentative definitions of *claims*?
2. Do Board members agree that there is sufficient promise to proceed with the claims approach?
3. Do Board members agree the framework team should continue to work on dual tracks – improving the liabilities definition and developing the claims approach?
4. Do Board members have any significant concerns that we have not yet identified about the potential implications:
   a. of one or both of tentative definitions of claims? (¶s 19-26)
   b. of the discussion of the characteristics of claims? (¶s 27-43)
   c. for recognition of claims? (¶s 48-55)
   d. for measurement of claims? (¶s 57-89)
   e. for financial statement presentation of claims and changes in them? (¶s 91-125)